CEPAL

Review

UNITED NATIONS
ECONOMIC COMMISSION FOR LATIN AMERICA AND THE CARIBBEAN
SANTIAGO, CHILE, DECEMBER 1991

CEPAL

Review

Santiago, Chile | December 1991 | Number 45

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CEPAL REVIEW No. 45

Macroeconomic policy coordination and integration

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Macroeconomic policy coordination is a new topic in the Latin American integration debate. In the light of pronounced macroeconomic instabilities in many Latin American economies, the recent efforts to revitalize regional integration schemes have led to an awareness that differences in national macroeconomic performance, as well as the instability *per se*, could frustrate advances in regional integration.

Both Argentina and Brazil still suffer from very high macroeconomic instability, and they have also embarked on an ambitious regional integration initiative known as "MERCOSUR". Their past and present integration efforts are therefore of special interest for analyzing the impact of macroeconomic policies on Latin American integration processes, as well as the scope and limits of regional macroeconomic policy coordination.

Whereas the Group of Seven (G 7) and the European Community (EC) used international coordination for internal macroeconomic stabilization, Argentina and Brazil would have to "put their houses in order" before trying true macroeconomic policy coordination. Moreover, the experience of the former suggests that a high degree of economic integration gives rise to a "virtuous circle" between integration and macroeconomic policy coordination. In contrast, a low degree of integration, as found within the Latin American Integration Association (ALADI), may impede such coordination.

Although the observable impact of Argentina's and Brazil's macroeconomic policies on trade is rather weak, this does not invalidate the need for future macroeconomic policy coordination. Sectoral and trade policies, as well as the internal instability in both countries, have so far obscured the macroeconomic effects on trade. However, the impact of the latter will increase if these policies are harmonized and a certain degree of stability is reached.

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Introduction

Until recently, the Latin American integration debate has paid very little attention to questions of macroeconomic policy coordination.[1] During the last few months, however, the need for and the problems of unifying the national macroeconomic policies have attracted increasing attention. This is due to two parallel developments. On the one hand, the recent past has seen the rise of a strong political will to revitalize regional integration schemes, aiming ambitiously at the establishment of free trade zones and common markets within a few years. On the other hand, whereas some Latin American countries have already made considerable progress towards stabilizing their economies, many still suffer from pronounced macroeconomic instability. This has led to concern over the extent to which differences in national macroeconomic performance, as well as the instability *per se*, will turn out to be a factor capable of frustrating the desired advance of regional integration. Notwithstanding the expressed willingness to address this problem by "harmonizing" or "coordinating" national exchange rate, monetary and fiscal policies, a systematic evaluation of the forms compatible with Latin American conditions and with the requirements involved is not yet available.

The problems posed are particularly relevant for the two largest South American countries, Argentina and Brazil. Both economies still suffer from almost unprecedented degrees of macroeconomic instability. Since the two countries have also launched one of the most ambitious regional integration initiatives –the so-called "MERCOSUR" (subsequently joined by Uruguay and Paraguay)–, their past and present integration efforts are of special interest for analyzing the impact of macroeconomic policies on the Latin American integration process, as well as for a discussion of the scope and limits of regional macroeconomic policy coordination.

Sections I and II of this paper are devoted to a discussion of the theory and practice of the relationship between economic integration and macro-

[1]For some of the few recent contributions, see Bekermann (1990), Halperin (1990), Lerda and Mussi (1987) and Tavares de Araujo (1990).

economic policy coordination. They outline the different theoretical patterns of interaction between these two concepts and present a brief account of the experience of the Group of Seven (G7)[2] and the European Community (EC) in this field. Whereas the experience of these two groups confirms the thesis that a high degree of economic integration and interdependence gives rise to a "virtuous circle" between integration and macroeconomic policy coordination, a low degree of interdependence, such as that found between the ALADI member countries, may produce a "vicious circle" in which the low degree of integration hampers such coordination, and vice versa.

The next two sections apply these general insights to the Argentine-Brazilian case. Section III gives an outline of their macroeconomic policy-making since 1985 –the year of the first serious efforts towards bilateral integration– and this permits an assessment of the extent to which the G7's and the EC's experience with macroeconomic policy coordination is applicable to the situation of these two countries. Although the concrete patterns adopted by the industrialized countries can hardly be imitated by the two Latin American States, their example permits a systematic evaluation of the forms and requirements involved in any effective international cooperation in this field. This evaluation is then used to delineate the scope and limits of collaboration between Argentina and Brazil. In section IV, the incidence of both countries' macroeconomic policies on their bilateral trade is examined from two perspectives. Although the observable impact on bilateral trade since 1985 is rather weak, this does not invalidate the need for macroeconomic policy coordination in a future free trade zone. The strong influence exerted on trade by sectoral and trade policies, as well as the high internal instability in both countries, have so far obscured the macroeconomic effects. However, their impact will increase if these policies are harmonized as planned and a certain degree of stability is reached. Finally, section V summarizes the main conclusions of this article.

I

Integration, interdependence and macroeconomic policy coordination

1. *Virtuous versus vicious circles*

Both political and economic scientists have discussed the meaning and the determinants of international economic interdependence.[3] The first-named are mainly interested in the overall influence of international economic relations on individual States, because the politicians' concern with interdependence is expected to rise with its potential impact on the national economic environment. Consequently, political science employs above all *average* indicators to measure the degree of economic interdependence, the most frequently used being the "degree of openness", given by the ratio of the value of international trade to GDP. Economists, for their part, focus on the impact of *marginal* changes in external economic parameters on internal aggregates and vice versa. Usually, these are analyzed with the help of income and trade elasticities of trade. According to a study by Keohane and Nye (1977), this difference may be characterized by the terms "vulnerability interdependence", meaning the overall exposure of a national economy to external developments, and "sensitivity interdependence", referring to the effects of marginal disturbances.

Obviously, the judgements of both groups about the degree of interdependence need not coincide. A low degree of openness makes the political scientist conclude that the overall vulnerability to external influences is of little concern to politicians and makes them feel little need for policy action. In contrast, adverse variations of external and internal parameters make economists stress the negative consequences for trade and its future development, however small their actual importance for the economy as a whole may be. Never-

[2] The Group of Seven (G 7) is made up of the major industrialized countries: United States, Canada, Japan, Germany, France, Italy and United Kingdom.

[3] For a discussion of this, see Cooper (1985).

theless, both viewpoints are profoundly interconnected since the degree of openness is the result of the accumulated sequence of marginal variations of internal and external determinants. Moreover, economic and political concerns converge with a rising degree of openness.

This interplay of average and marginal determinants of a country's exposure to its international environment is of particular importance for the relation between economic integration and macroeconomic policy coordination.[4] It provides the basis for assuming, on the one hand, a positive relationship between the degrees of economic integration and interdependence and, on the other hand, an inverse relationship between the degree of interdependence and the effectiveness of national macroeconomic policy-making.The first is presumed to be positive because of the effects of economic integration on the variables which define economic interdependence. By demolishing barriers to trade, economic integration is expected to increase trade between the countries involved, thus raising their degree of openness. Additionally, international flows of goods and factors of production increase their responsiveness to changes in relative prices and demand if their markets become unified, which is equivalent to saying that their price and income elasticities of trade increase.

When the degrees of economic integration and interdependence rise, national macroeconomic policies will find their effectiveness more and more limited, because higher international mobility of goods and factors tends to erode the domestic effects of these policy actions and causes unexpected and unwelcome spill-over effects in other, interconnected economies. This gives rise to a desire to reduce and control the disturbing effects of these movements by an appropriate international combination of national macroeconomic policy actions. It is important to note that in such circumstances, possible conflicts between the pursuit of national and international macroeconomic objectives cease to matter as national sovereignty over macroeconomic instruments is gradually eroded. In situations of high economic interdependence, international coordination of macroeconomic policies can even help to recover control over the domestic economy. Since the coordination of macroeconomic policies reduces the disturbances caused to trade by unrelated national measures, the development of commercial relations is expected to be favoured in turn.

However, if a group of countries is characterized by a rather low level of mutual economic interdependence, it is improbable that their efforts towards more integration will enjoy the benefit of such a self-sustaining "virtuous circle" between integration and macroeconomic policy coordination. In contrast, the danger of a "vicious circle" arises because a lack of such coordination can effectively block any advance in economic integration if it causes substantial and permanent distortions of the conditions for trade. Moreover, the will to promote macroeconomic coordination may be rather limited, since the net national costs of such international coordination are imminent and high, whereas the benefits can only be reaped in an uncertain future. In comparison with the former case, these costs are higher because, on the one hand, limitations imposed by any international commitments on the scope of domestic action can easily conflict with the need to pursue purely national objectives. On the other hand, the benefits of cooperation are low because the vulnerability of the domestic economic situation to adverse external events is limited. In these circumstances, the lack of coordination of macroeconomic policies can prevent the degrees of economic integration and interdependence from reaching a stage which would lead to the initiation of the "virtuous circle" described earlier.

2. *Economic interdependence: some empirical evidence*

According to the key elements set out in the previous section, a complete evaluation of the existence of a virtuous or vicious circle between the efforts at economic integration and macroeconomic policy coordination would have to give evidence of a correlation between, on the one hand, rising price and income elasticities of trade and degrees of openness between the countries considered, and, on the other hand, increased levels of macroeconomic policy coordination.

Table 1 shows the degree of openness for the member countries of the G7, EEC and ALADI, as well as for the groups as a whole. The first column gives the figures for total trade, the second for trade within the group. All these groups show two common tendencies: firstly, within each group, the

[4]For an early discussion of the interrelation of integration and interdependence, as well as their appropriate measures, see Tollison and Willett (1973).

degree of openness varies inversely with the size of the economies, and secondly, the smaller the economy, the more important becomes intra-group trade in relation to extra-group trade.

Table 1

G 7, EEC AND ALADI: TOTAL AND INTRA-GROUP TRADE[a]

(As a percentage of 1989 GDP)

	Total trade	Intra-group trade
GROUP OF SEVEN (G7)		
Canada	41.9	35.2
France	38.9	18.6
Fed. Rep. of Germany	50.9	21.5
Italy	32.3	16.7
Japan	17.1	7.6
United Kingdom	42.1	20.0
United States	16.6	8.5
Total[b]	**28.4**	**14.2**
EUROPEAN ECONOMIC COMMUNIITY (EEC)		
Belgium and Luxembourg	122.8	89.2
Denmark	52.3	27.5
France	38.9	25.1
Fed. Rep. of Germany	50.9	25.7
Greece	32.6	29.8
Ireland	117.0	80.7
Italy	32.3	18.5
Netherlands	94.8	70.8
Portugal	84.5	60.2
Spain	30.5	18.6
United Kingdom	42.1	20.3
Total[b]	**47.3**	**27.7**
LATIN AMERICAN INTEGRATION ASSOCIATION (ALADI)		
Argentina	25.7	7.1
Bolivia	54.3	27.2
Brazil	21.2	2.6
Chile	55.0	10.2
Colombia	31.7	4.7
Ecuador	48.0	7.8
Mexico	37.1	1.1
Paraguay	50.7	20.1
Peru	36.5	7.5
Uruguay	51.8	22.0
Venezuela	72.9	5.3
Total[b]	**33.0**	**4.0**

Source: ALADI, ECLAC, IMF.
[a]Imports and exports of goods and services.
[b]Weighted average.

There are marked differences between the degree of openness towards the own group and the rest of the world among these country groups. For all the EC countries except the United Kingdom, trade with the other member countries is more important than trade with the rest of the world: a result which is also observed for the G7 as a whole. In contrast, the figures for the ALADI countries display, on the one hand, a low level of trade relations with the other ALADI countries, while on the other hand the degree of openness towards the rest of the world is, for the group as a whole and for all its member countries except Argentina and Brazil, higher than that of the two groups of industrialized countries.

Figures 1 and 2 show the historical evolution of the degree of openness of ALADI and the EEC towards their own group and the rest of the world. Again, the differences are remarkable. Whereas ALADI's indicators do not show any significant changes from 1970 to 1989, the proportion of intra-EEC trade to GDP shows almost uninterrupted rapid development, more than doubling from 12.7 % in 1960 to 28.8 % in 1990. In contrast, the EC's degree of openness to the world has recently fallen back to a level which is even lower than that in 1960, after rising to a higher level between 1974 and 1985.

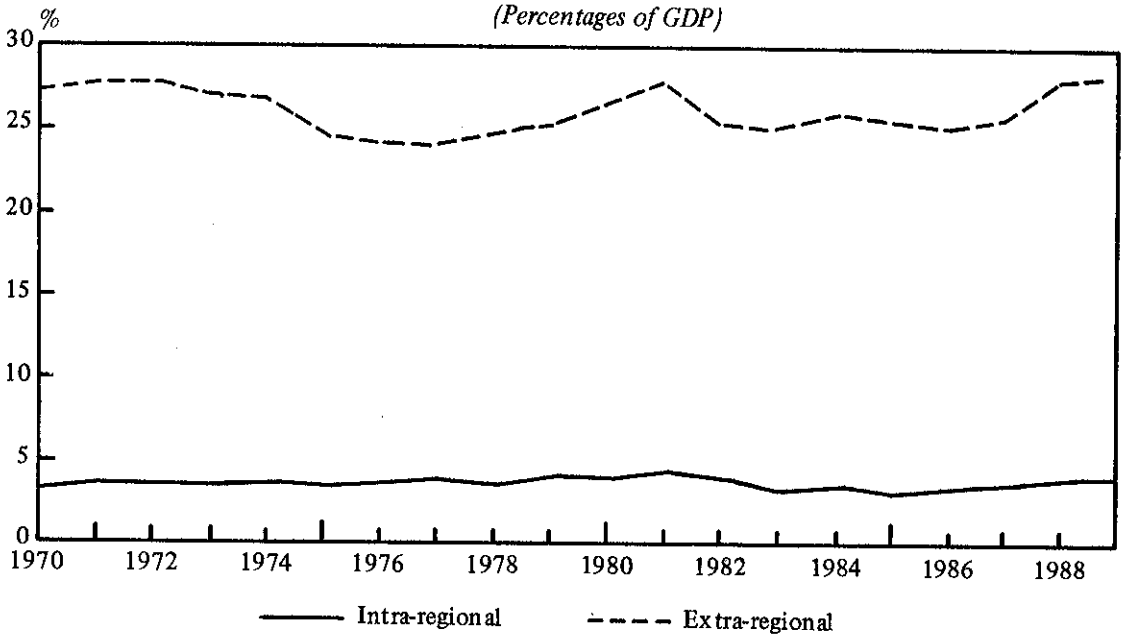
These observations permit the following conclusions: In marked contrast to the situation among industrialized countries, the trade relations among Latin American countries represent such a low proportion of their GDP that variations in intra-regional trade cannot be expected to produce notable repercussions in the national economies. The figures suggest that the Latin American economies are much more exposed to the effects of macroeconomic policies adopted by the industrialized countries.

For the EEC, the evolution of the degrees of openness towards the own region confirms the hypothesis that a higher degree of economic integration leads to dynamic growth of trade. Moreover, a comparison of this indicator with the degree of openness towards the rest of the world provides a clear illustration of the classical assumption that economic integration promotes trade creation among the group of countries involved, as well as trade diversion away from the rest of the world.

Figure 1

ALADI: INTRA- AND EXTRA-REGIONAL TRADE, 1970-1989

(Percentages of GDP)

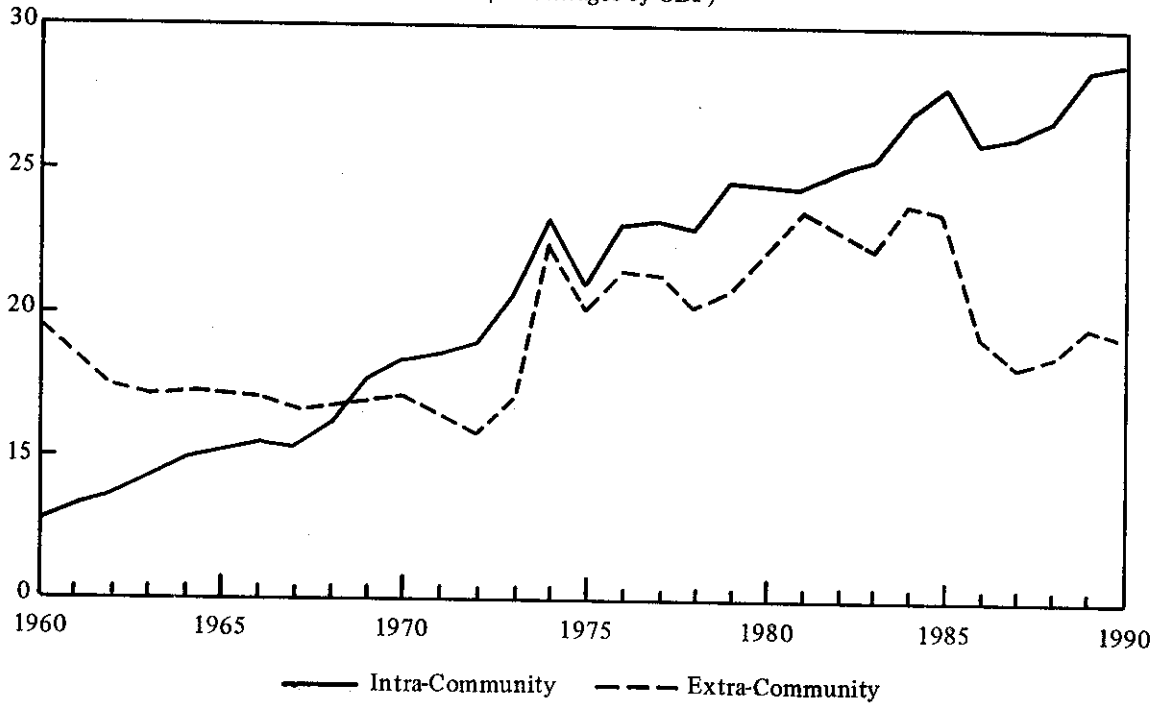


Source: ALADI and United Nations Statistical Office.

Figure 2

EEC: INTRA- AND EXTRA-COMMUNITY TRADE, 1960-1990

(Percentages of GDP)



Source: EEC and United Nations Statistical Office.

In comparison, the evolution of both intra-ALADI and extra-ALADI trade with respect to GDP was found to stagnate over the time period considered. This can be taken as a rough indicator that this country group has neither increased its internal degree of integration, nor its interdependence with the rest of the world.

As regards the international transmission of macroeconomic policy effects, the literature has almost exclusively concentrated on examining the policy spill-overs among industrialized countries, whereas much less attention has been given to the incidence of the industrialized countries' macroeconomic policies on developing countries, and analyses of these repercussions within the developing countries are extremely rare.[5]

A recent study (Bryant *et al.* (1988)) has compared the projections of twelve large-scale models for the industrialized countries. The results confirm that the effects of national macroeconomic policies on other countries are considerable, and that their overall economic impact varies inversely with the degree of openness.

For example, the models predict that an increase in US fiscal expenditure equivalent to 1% of US GDP raises the GDP of the other OECD countries by approximately 0.4%. If, however, the latter countries expanded their fiscal expenditures by the same amount, the effect on US GDP would be only half as large, namely 0.2%.

Due to these substantial effects of macroeconomic policies on the performance of other, interconnected economies, it can be appreciated that national policy-makers have felt the need to align their macroeconomic policies. The next section gives a brief account of the G7's and the EEC's efforts in this field.

II

Macroeconomic policy coordination in the EEC and the G7

As regards international macroeconomic stability, the time after World War II is divided into two periods. During the first, extending until the beginning of the 1970s, the international arrangements known as the Bretton Woods System guaranteed a high degree of exchange rate and price level stability among the industrialized countries, contributing to fast growth of international trade and national output. Nevertheless, the system implied a considerable loss of national autonomy in the use of macroeconomic policies.

The system broke down because of three developments: firstly, increasing international capital market integration and the rapid growth of so-called "offshore" financial markets gave rise to substantial short-run capital movements which made it increasingly difficult to defend exchange rate stability. Secondly, growing internal economic pressures –among them, the economic consequences of the Vietnam war– made the US less inclined to play the role of the international guarantor of stability. Thirdly, economic theory had begun to favour a system of flexible exchange rates because it seemed to be more appropriate for reducing the persistent current account disequilibria and the destabilizing impact of capital movements. Moreover, it would provide greater national autonomy over macroeconomic policies.

However, these expectations were quickly frustrated when exchange rates were allowed to move freely. The short-run volatility and the "overshooting" of exchange rates was seen to constrain the growth of international trade[6]. Besides this, the medium-run divergence of exchange rates from what was believed to be their long-run equilibrium values was seen to lead to a waste of economic resources as their allocation followed incorrect international price signals. Moreover, uncoordinated national policy responses to real shocks, above all the oil price increases, proved to be rather ineffective and to have unwanted repercussions in the other economies.

[5]As an example of the latter, see Gasiorowski (1985).

[6]For a theoretical and empirical examination of the effect of exchange rate volatility on trade, see De Grauwe (1988).

For these reasons, the need for new forms of international macroeconomic policy coordination was quickly felt. Since 1975, the so-called Group of Seven (G7), comprising the world's largest industrial nations, instituted regular meetings of their heads of government and ministers of finance to discuss international economic problems and agree on concerted actions.[7] Until 1979, the countries, inspired by the Keynesian model, pursued international demand management through tightly coordinated policies. When leaders who followed monetarist policy advice took office in almost all the countries however, this coordination changed to rather loose cooperation, aiming at convergence of the national macroeconomic performances by attacking, above all, domestic inflation rates through the macroeconomic policy combinations appropriate to the individual cases.

A move towards tighter cooperation followed the success in stabilizing short-term exchange rates achieved through the concerted action known as the Plaza Agreement in 1985. However, increasing attention had been drawn to the macroeconomic causes for the changes in medium-term levels of exchange rates, in particular the dramatic real appreciation of the US dollar until 1985 and its subsequent decline to historically low levels in 1990 and 1991; for a long time there was broad disagreement between the US, on one side, and Germany and Japan on the other, regarding the cause and the cures for this phenomenon. The latter countries argued that the appreciation of the dollar had been a consequence of US deficit spending which, due to high interest rates, attracted foreign capital and, at the same time, allowed US absorption to rise relative to production; the US, however, maintained for a long time that the higher US interest rates and imports only reflected rising US productivity, as produced by microeconomic policy reforms. Even when this opinion became increasingly unsustainable, opinions varied substantially on the most appropriate way to address the US current account deficit through concerted international action. Thus, Japan and Germany insisted that a reversal of the situation would have to come by way of a reduction in the US budget deficit, whereas the US –unsuccessfully– proposed the adoption of expansive fiscal policies by those countries in order to stimulate US exports.

Compared with the variety of objectives and patterns of macroeconomic policy coordination pursued by the G7, the EEC has shown, in contrast, firm dedication to building a zone of high nominal stability of exchange rates and monetary variables, while on the other hand it has made an ambitious attempt to use tight international cooperation as a mechanism for stabilizing the domestic macroeconomic environment of its member States[8].

The reasons for the concern with stable exchange and interest rates were threefold: Firstly, the stability reached through the *de facto* coordination of macroeconomic policies under the Bretton Woods System was seen as a decisive factor for the progress of European integration during its first decade. Secondly, this situation of nominal stability resulted in an intra-EC trade regime which was characterized by the lack of any national mechanisms to protect against external macroeconomic disturbances, and consequently, trade was felt to be extremely vulnerable to such instability. Thirdly, the functioning of the Common Agricultural Policy's (CAP) price setting mechanisms depended heavily on nominal and real exchange rate stability.

The quest for internal stabilization through external commitments was primarily pursued by means of the European Monetary System (EMS), established in 1978, and took three principal forms.[9] The member States agreed to internal realignments of exchange rates which did not fully reflect inflation rate differentials. This put pressure on countries with relatively high inflation rates to pursue internal anti-inflationary policies. Moreover, the weight of national currencies in the common monetary unit, the ECU, was fixed in percentages instead of nominal amounts, which gave the ECU a built-in bias towards stability. Finally, smaller and less stable member countries discovered that they could effectively gain internal policy credibility for domestic disinflation policies by joining the EMS.

[7] For a historical account of the G7's experience, see Putnam and Bayne (1987).

[8] Among the abundant literature on the theme, see for example Briz de Labra and Carbajo Vasco (1988) and Van der Ploeg (1989).

[9] For a non-technical review of the arguments, see Bank of England (1991).

However, this advantage of "tying one's hands" by importing EMS stability, as well as the whole attempt to use the EMS as an instrument for the convergence of member countries' national inflation rates at a lower level[10], depended crucially on the existence of a member country –the Federal Republic of Germany– which was, on the one hand, firmly dedicated to internal monetary stability and, on the other hand, was sufficiently large to absorb the potentially disturbing effects of the role of a stabilizing anchor. Moreover, given the crucial importance of EC trade and investment for German economic prosperity, the benefits to Germany arising from EC-wide macroeconomic stability were seen to outweigh the costs involved in such a role.

As well as identifying their specific circumstances, the examples of these two groups of countries make it possible to classify the various forms of macroeconomic cooperation, as well as to identify its essential prerequisites. According to the degree of intensity of cooperation, Steinherr (1984) distinguishes the following main forms:

– *exchange of information*, the least intensive form of cooperation;

– international *agreement on the objectives* to be pursued by appropriate though not necessarily coordinated national macroeconomic policies, in order to lead to economic convergence;

– *harmonization* of macroeconomic policies, which means the adoption of common rules for these policies. By reducing the scope for discretionary action, this is expected to lead to greater uniformity of the economies in the medium and long run;

– *coordination* of discretionary, short-run actions. This is the most intensive form, requiring agreement on mutually consistent target values, as well as the concerted selection and use of national macroeconomic instruments.

To put any of these forms of co-operation into effect, two basic requirements have to be fulfilled:

– policy-makers must share a common view on the "global macroeconomic model", i.e., the way in which the main determinants of the macroeconomic environment interact; otherwise, divergent perceptions of the causes of international problems lead to differing recommendations on the appropriate cures and make lasting concerted action improbable.

– national policy-makers must have effective control over their set of macroeconomic instruments. Otherwise, compliance with any international commitment may be found not to be feasible.

III

The macroeconomic situation of Argentina and Brazil, 1985 to 1990

1. *Macroeconomic policies in Argentina and Brazil, 1985-1990*

A first step towards analyzing the need for and problems of macroeconomic coordination in the case of Argentina and Brazil is to give a brief account of the main features of macroeconomic policy-making in both countries. As a starting point, 1985 was chosen because the first concrete steps towards bilateral integration were undertaken in that year.

Both countries show great similarities in the patterns of their macroeconomic policies. This is true of the principal objectives pursued and the instruments used, as well as of the problems encountered. Although both countries' macroeconomic instability originated primarily from external imbalances, it has subsequently been aggravated by two internal developments: the economic agents' increasing ability to hedge against domestic macroeconomic fluctuations, and the loss of credibility of macroeconomic policy-making[11], stemming from the incapacity to restore the internal monetary and fiscal balances.

[10]For a theoretical discussion of this argument, see Giavazzi and Pagano (1988). For an application to the case of Ireland, see Kremers (1990).

[11]A study on the rising level of credibility in macroeconomic policy-making is given by Persson (1988).

During a first period, which started with the Austral Plan in Argentina and the Cruzado Plan in Brazil, both governments thought they could reduce inflation without recessionary consequences by adopting so-called "heterodox policies". Inflation was mainly attributed to an inertial element arising from economy-wide indexation. Consequently, price and wage freezes, as well as monetary reforms, were at the heart of the stabilization plans implemented. Although this strategy was successful in the short run, it proved to be unsustainable in the long term. This can be attributed to three factors: Firstly, the inertial element was just one of the causes of high and rising inflation, and the governments did not effectively combat the second cause, which was constituted by the fiscal deficits. Secondly, the artificial freeze of relative prices over a prolonged period of time made economic agents turn to political pressure to improve their economic situation. Thirdly, the price freeze maintained pronounced disequilibria between aggregate demand and supply. In the case of Brazil, the excess demand led to other clandestine forms of price increases and an import surge. In Argentina, depressed aggregate demand led to a general recession.

Under the impact of the failure of this strategy, both governments tried to form "social pacts" between the conflicting economic groups in order to ensure the success of subsequent price freezes. However, the attempts at stabilization undertaken in 1989 failed again. This was partly due to the ability of some economic groups to improve their initial position at the expense of others. However, it was due above all to the governments' incapacity to take effective measures against the public deficits, which made the public increasingly skeptical about the sustainability of the stabilization efforts undertaken. Preventive action then taken against a perceived revival of high inflation rates contributed substantially to the breakdown of the stabilization plans.

At the beginning of 1990, both countries changed their macroeconomic strategy and adopted restrictive fiscal and monetary policies. Fiscal austerity addresses the problem of public debt and deficits, whereas tight monetary policies try to contain inflation rates. The strong recessionary consequences induced an abrupt fall of inflation rates, accompanied by a real revaluation of both national currencies. However, any doubt about the governments' determination to reduce fiscal disequilibria induces the public to take preventive action to forestall the anticipated unsustainability of the current situation. This, in turn, has great potential for destabilizing the domestic environment, in the manner of a self-fulfilling prophecy.

Besides inflation rates, real interest rates have become ever more responsive to internal changes. Both demand and supply of foreign currencies –above all, the US dollar– have become increasingly unstable. Whilst short-term demand is mainly influenced by economic agents' desire to buy foreign exchange as a hedge against expected rebounds of inflation, supply is highly responsive to changes in real domestic exchange rates. Consequently, real exchange rates of both countries show a considerable short-run volatility which is much more a reflection of quickly changing expectations on internal developments than the counterpart of trade flows.

2. *The scope and limits of the EEC's and G7's experience as a model for the Argentine-Brazilian case*

In the previous section it was argued that a lack of credibility is at the heart of Argentina's and Brazil's macroeconomic instability. It is worthwhile asking now if the EEC's attempt to use external macroeconomic commitments to aid internal stabilization could also be used by Argentina and Brazil. Due to differences in size, it would be more probable that Argentina could benefit from Brazil in this way than vice versa. However, it must be remembered that the EEC's success depended crucially on the existence of a large, stable and interested country as the anchor of the system. The current instability of both countries makes it improbable that an attempt to imitate the European example in this sense could be successful.

Secondly, although the variability of the real exchange rates of both these countries is more accentuated than that observed among the industrialized nations, the stress placed by the latter on exchange rate stabilization was primarily motivated by the spill-over effects. These, in turn, originated in the high degree of capital mobility produced by capital market integration and the full

convertibility of the currencies in question. These conditions do not exist in the Argentine-Brazilian case. Here, exchange rate changes are mainly home-made and do not have any immediate repercussions on the other economy, although erratic movements may be of concern for bilateral trade.

Thirdly, the recourse taken in both countries to ever more drastic macroeconomic measures reflects the loss of credibility and the increased capacity of private agents to protect themselves against the impact of the policy measures taken. This has made macroeconomic instruments increasingly ineffective. Although both governments coincide in their perception of the causes and cures of their macroeconomic problems –and thus, in principle, fulfill one of the fundamental requirements for cooperation in this field–, the control over the respective national instruments has deteriorated to such an extent that any attempt at true macroeconomic policy coordination is difficult to implement.

Consequently, it follows that the only feasible forms of cooperation between the two countries are those which are less intensive and demanding in the short run. Given the congruence concerning macroeconomic objectives, it can be said that both countries are already pursuing –albeit indirectly– a convergence of their economies towards a similar level of stability. The particular problems of each country and, above all, the threat of quickly destabilizing internal developments, mean that policy-makers must be able to choose and change their policies, which makes prior international commitments on the rules or instruments used rather undesirable.

In sum, the current macroeconomic situation in both countries makes it indispensable that both "put their house in order" by adopting the policy measures which are appropriate to their individual cases. More ambitious forms of macroeconomic policy coordination will only become feasible after both economies have converged towards a considerably higher level of overall stability.

IV

The influence of macroeconomic policies on bilateral trade

1. *1985 - 1990*

Macroeconomic policies are expected to influence trade through two channels: firstly, through their impact on national production costs, above all wages and interest rates, and on the international prices of national products, as determined by the exchange rate, and secondly, through the evolution of internal demand as reflected in the demand for imports and the supply of exports.

To assess the evolution of the first set of parameters, figure 3 illustrates the evolution of the bilateral real exchange rate and bilateral real wages in Argentina's and Brazil's manufacturing sectors. In comparison to the evolution of real bilateral wages, the evolution of the real exchange rate between Argentina and Brazil had been relatively stable until the beginning of 1989. During 1989 and 1990, however, it showed a high degree of instability and a trend towards a higher level for Argentina. Real wages, however, showed much more pronounced variability and multiplied the movements of the exchange rate. Both indicators gave grounds for predicting that Argentine exports should have increased their bilateral competitiveness *vis-à-vis* Brazilian production, especially during 1989 and 1990. This, in turn, should have led to reduced bilateral imports and increased exports.

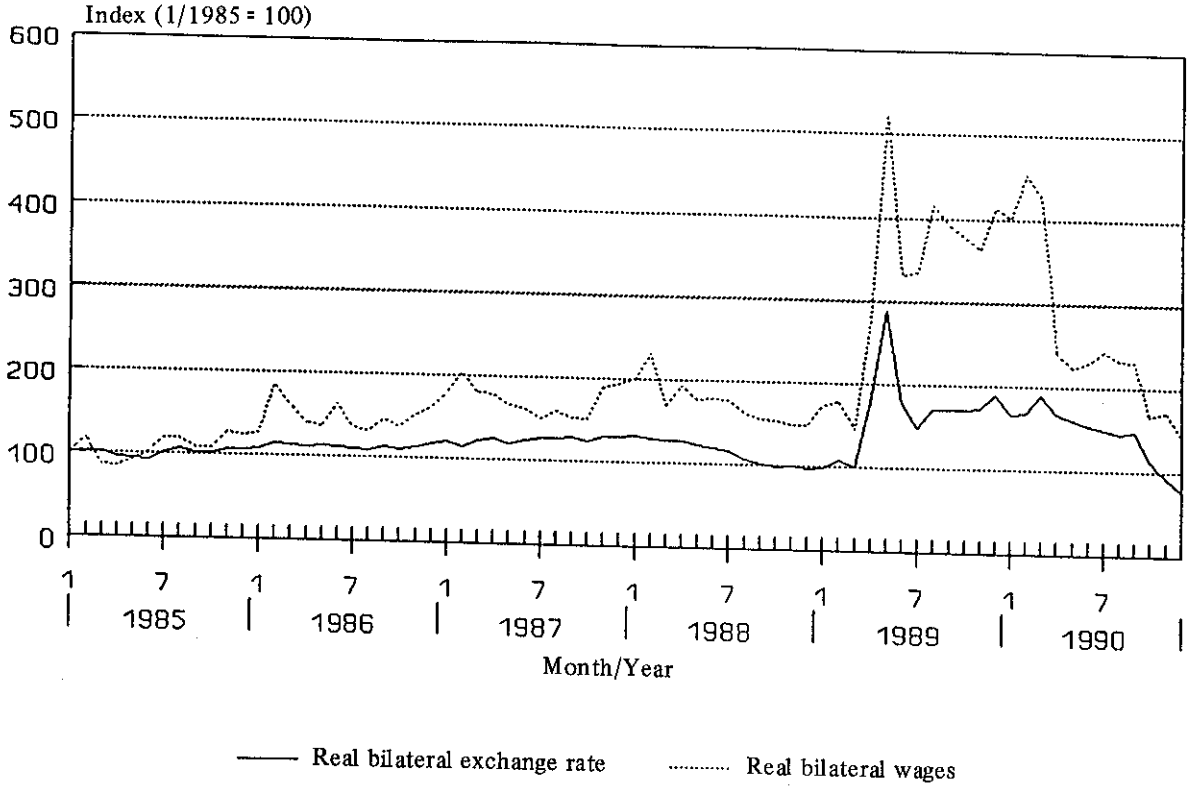
Turning to the second factor, the evolution of internal demand, figure 4 shows the development of both countries' GDP, as well as the difference between their growth rates. Brazil's growth rate has in general exceeded that of Argentina during the period observed, although both countries suffered a gradual decline of their GDP after 1986. In general, this growth pattern may be assumed to have stimulated Brazilian imports from Argentina and, during periods of high internal demand, to have reduced bilateral exports.

The trade figures shown in table 2 provide some confirmation of these hypotheses[12]. Espe-

[12] The data available were insufficiently detailed and the time horizon too short for a rigorous statistical examination of the hypotheses, however.

Figure 3

ARGENTINA AND BRAZIL: REAL BILATERAL EXCHANGE RATES AND WAGES, 1985-1990[a]



Source: Argentina: *El Economista.*
Brazil: Getulio Vargas Foundation, *Conjuntura Econômica.*
[a]A rise in the indexes represents bilateral monetary devaluation or a drop in real wages for Argentina.

cially in 1986 and 1989, Brazil's strong internal demand can be seen to be reflected in the large increases in imports from Argentina, and in 1989 the sharp and prolonged change in the exchange rate obviously contributed to this development. For the case of Argentina, the pronounced recessions of 1985 and 1989 are reflected in reduced imports, whereas in the other years these increased despite the relatively adverse evolution of internal growth. This can partly be explained by the sectoral composition of imports. Two sectors, chemicals and steel products, have consolidated their share in bilateral imports, reaching 56% of the total in 1989. Both these sectors have considerably increased their export orientation during the period observed, partly because of the export promotion measures introduced in 1985[13] and the problems posed by large-scale production processes facing slack internal demand. In this sense, purchases from Brazil in these sectors had the role of imports for increasingly export-oriented industrial activities. In this context, the repercussions of the internal demand situation are naturally very limited. Moreover, the State's interest in the development of these sectors might have tended to mitigate the adverse effects of the macroeconomic environment.

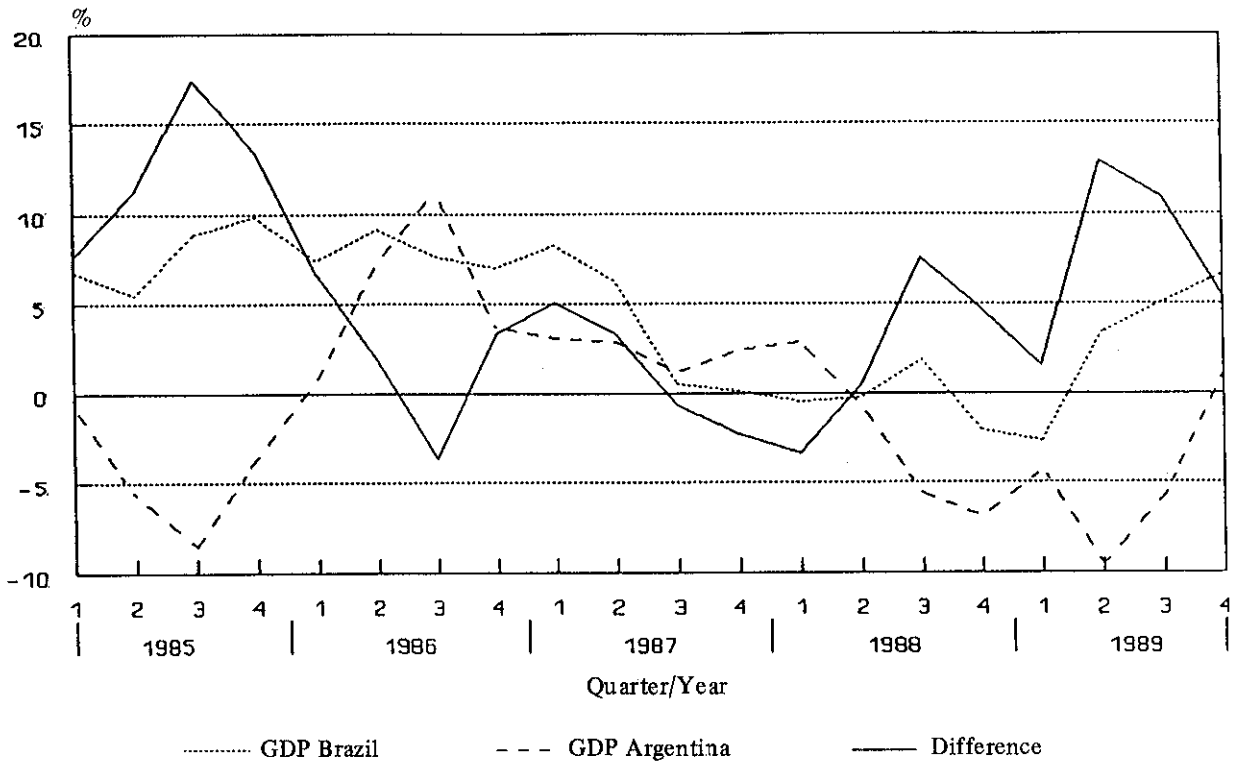
Besides these observations, the reduced responsiveness of bilateral trade flows, especially to exchange rate changes, could be attributed to the protection against internal macroeconomic instability provided by the export promotion policies in both countries. For example, the Brazilian export financing system protects exporters effectively against real exchange rate changes and internal interest rate fluctuations[14]. In other words, a relatively adverse external environment might still have

[13] For an analysis of the Argentine industrial export promotion policy, see ECLAC (1990).

[14] For a recent evaluation of the financial incentives provided, see Ribeiro Ratto (1989).

Figure 4

ARGENTINA AND BRAZIL: ECONOMIC GROWTH, 1985-1989



Source: Argentina: Latin American Economic Research Foundation (FIEL).
Brazil: Getulio Vargas Foundation.

been preferable to the conditions prevailing in the internal markets.

2. *The MERCOSUR context*

In the context of the future MERCOSUR, the planned harmonization of sectoral and commercial policies, as well as including a general tendency towards reducing the State's role in industrial and commercial activities, will reduce the impact of the aforementioned measures to combat internal and external macroeconomic instability. Moreover, effective reduction of tariff and non-tariff barriers is expected to raise the participation of private economic agents in bilateral trade and give rise to bilateral investment. The impact of macroeconomic policies and instability on bilateral trade could then be expected to increase considerably.

Above all, the questions related to exchange rate changes will then gain importance. Besides the necessity of reducing exchange rate volatility, since this constitutes a cost to trade activities, the question of how to determine and defend a suitable real bilateral exchange rate will undoubtedly be of particular concern[15]. Whereas the solution of the first problem will depend on the efforts to reduce internal macroeconomic instability, any solution to the second will have to be related to a situation in which both countries have gained sustainable macroeconomic equilibria. For these two reasons, the attainment of a situation of macroeconomic convergence towards a stable level in both countries will become a crucial factor in the process of constructing the future free trade zone between both nations. If, however, macroeconomic stabilization cannot be achieved, the increasing negative impact of macroeconomic distortions on bilateral trade and investment will most probably become a major obstacle to the completion of MERCOSUR.

[15] For a methodological discussion of the various alternative ways of defining a suitable medium-run exchange rate, see Williamson (1983).

Table 2

ARGENTINA: STRUCTURE OF TRADE WITH BRAZIL, 1984-1989
(In thousands of current dollars)

	1984	1985	1986	1987	1988	1989
1. *Exports to Brazil*						
Food and live animals	201 656	197 137	378 066	247 074	236 530	526 897
Wheat	107 323	105 811	76 863	96 176	88 081	158 366
Vegetables	17 638	21 691	54 142	37 092	39 493	58 085
Apples	26 095	24 771	35 099	32 059	23 492	28 199
Beverages and tobacco	72	191	633	307	559	3 364
Crude materials, inedible	40 571	11 979	16 952	22 533	29 860	28 336
Mineral fuels	20 440	63 474	23 380	84	4 109	19 344
Oils, fats, waxes	69 728	70 345	41 972	25 396	37 425	43 990
Chemical products	37 449	38 345	47 253	64 153	112 533	129 452
Organic chemicals	12 991	13 859	9 363	23 331	67 760	53 152
Inorganic chemicals	14 462	14 307	23 503	23 338	28 048	35 662
Manufactured goods	68 061	54 179	106 184	79 414	51 864	175 481
Leather	59 314	47 598	89 039	40 014	11 192	9 813
Machinery and transport eqpt.	31 612	50 079	65 695	84 629	111 239	159 203
Industrial machinery	5 128	5 100	9 718	16 577	17 350	33 313
Office machines	415	480	3 508	4 881	11 410	9 888
Electrical machinery	2 390	4 835	6 813	3 724	3 149	9 900
Vehicle motors	84	4 999	7 212	8 278	10 803	14 364
Vehicle parts	22 664	33 808	33 332	33 118	32 044	49 644
Miscellaneous manuf.	8 563	10 524	17 718	15 646	23 698	38 096
Commodities n.e. classified	58	38	216	95	144	267
Total	**478 210**	**496 291**	**698 069**	**539 331**	**607 961**	**1 124 430**
2. *Imports from Brazil*						
Food and live animals	106 008	76 083	109 346	89 287	66 943	45 884
Coffee	34 348	24 127	50 998	28 994	17 132	13 062
Beverages and tobacco	44	84	1 085	1 527	1 934	2 769
Crude materials, inedible	116 825	99 819	122 667	125 868	132 079	166 098
Iron ore	66 260	70 290	86 675	87 094	92 954	132 806
Mineral fuels	11 186	18 119	867	31 135	51 051	2 218
Oils, fats, waxes	1 291	1 952	1 137	1 019	1 169	1 015
Chemical products	195 432	137 583	168 822	181 030	220 971	191 816
Organic chemicals	67 863	49 726	80 790	95 538	112 369	117 399
Inorganic chemicals	11 844	7 750	12 275	11 339	13 882	12 623
Manufactured goods	216 928	113 396	109 665	145 516	270 125	140 147
Iron and steel	137 844	60 770	34 475	63 650	186 445	80 903
Machinery, transport eqpt.	162 807	147 010	158 244	221 797	207 314	159 658
Industrial machinery	25 967	23 338	26 385	35 438	43 553	34 521
Office machinery	19 399	17 684	10 718	11 363	12 288	10 199
Electrical machinery	38 865	29 074	36 302	32 629	34 200	26 743
Vehicle motors	8 898	8 858	14 642	16 650	20 152	14 327
Vehicle parts	41 822	36 902	44 235	63 291	56 481	41 949
Miscellaneous manuf.	20 566	17 397	19 074	21 247	19 248	10 999
Commodities n.e. classified	51	86	374	795	543	670
Total	**831 138**	**611 529**	**691 281**	**819 221**	**971 377**	**721 274**
Trade balance	**(352 928)**	**(115 238)**	**6 788**	**(279 890)**	**(363 416)**	**403 156**

Source: United Nations Statistical Office (UNSO), International Commodity Trade Data Base (COMTRADE).

V

Conclusions

The main results of this article can be summarized in the following six statements:

1. A high degree of economic integration and interdependence, as observed in the case of the G7 and EEC member countries, produces almost automatically the need for macroeconomic policy coordination, which, if carried out successfully, in turn favours economic integration. In contrast to this "virtuous circle", a low degree of economic interdependence, as found among the ALADI member countries, makes macroeconomic policy coordination less urgent from the national viewpoint and more costly in terms of national sovereignty. If this lack of coordination has a significant negative impact on economic relations, it constitutes an important barrier against raising the degree of economic integration and interdependence, which consequently leads to a "vicious circle". In this situation, macroeconomic policy coordination is a prerequisite for, rather than a consequence of, progress in economic integration.

2. Due to the specific patterns and circumstances of macroeconomic policy cooperation among the G7 and EEC countries, most of their lessons can hardly be applied to the Latin American case. For the G7, this stems above all from the decisive role played by the high degree of financial market integration: a factor which does not yet exist in Latin America. For the EEC, the lack of comparability is attributable firstly to the *de facto* macroeconomic policy coordination produced by the Bretton Woods System during the first fifteen years of the EEC's existence (until the beginning of the 1970s) and secondly, to the fact that the subsequent endeavours to implement mechanisms which coordinate *nominal* monetary variables and exchange rates in order to achieve the reduction and convergence of national inflation rates (and, in some cases, to gain domestic credibility for disinflation policies) can only be effective if a relatively low level of initial macroeconomic instability exists, and if the larger economies involved display a high degree of macroeconomic stability.

3. Nevertheless, the experience of the G7 and the EEC allows some general guidelines to be drawn for international macroeconomic policy coordination. The concrete objectives and intensity of macroeconomic policy cooperation can vary widely over time, ranging from the pursuit of an overall convergence of national macroeconomic performance, by means of rather uncoordinated internal policies, to a genuine coordination of discretionary actions in order to reach jointly agreed macroeconomic targets. However, two basic requirements must be met for any form of successful international cooperation: Firstly, the policymakers of the different nations involved must share a common view on the broad functioning of the macroeconomic environment, since this makes them agree on the causes and cures for international macroeconomic problems. Secondly, national authorities must have control over their domestic macroeconomic instruments in order to produce the internationally desired effects.

4. Although Argentina's and Brazil's macroeconomic instability originated primarily from external imbalances, it has been subsequently aggravated by two internal developments: the economic agents' increasing ability to hedge against macroeconomic fluctuations, and the erosion of the credibility of macroeconomic policymaking, stemming from the incapacity to restore the internal monetary and fiscal balances. Both factors have rendered the use of macroeconomic tools increasingly ineffective. Consequently, one of the aforementioned fundamental requisites for the coordination of macroeconomic policies is currently not fulfilled, even though at present the national policymakers' viewpoints about the causes of instability broadly coincide, as may be seen from the priority given in both countries to the restoration of fiscal balances. Accordingly, any attempt to secure true and close coordination of macroeconomic policies requires the recovery of internal stability, which, in turn, depends on regaining internal credibility for macroeconomic policy-making.

5. During the (relatively short) time span considered, trade flows between the two countries have been found to react to macroeconomic influences only if these were of substantial magnitude and duration. The impact of changes in

economic activity has been evident, but the incidence of the considerable fluctuations of relative bilateral prices (exchange rates, labour and financial costs) has been less notable. This is seen to be attributable to two factors: Firstly, a considerable proportion of bilateral trade still consists of products of special national importance, which are covered by special sectoral policies and/or intergovernmental trade agreements, which presumably reduces their sensitivity to macroeconomic variations. Secondly, the elaborate structure of national trade policy schemes may have reduced the level of risk of foreign trade activities *relative* to the considerable uncertainties faced in the internal markets, thus making international commercial activities still more attractive.

6. Both these elements are expected to lose importance in a future free trade zone. To the extent that sectoral policies are harmonized, a certain degree of internal stability is reached, and the significance of private trade and investment activities is increased, the effects of macroeconomic changes –in particular exchange rate variability and misalignments– on the development of bilateral economic relations will become increasingly significant. Since the importance of bilateral trade for the global economic performance of both countries is still relatively limited, however, it is difficult to see how attempts at tight coordination of macroeconomic policies could survive situations of conflict between the pursuit of national objectives and the goals of cooperation. This, together with the high degree of macroeconomic instability which still exists in both economies, suggests that the pursuit of convergence of the macroeconomic performance of both countries towards sustainable equilibria by means of (not necessarily coordinated) internal policies is more desirable and more feasible than attempts to attain some form of genuine macroeconomic policy coordination.

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